7 May 2018

Misconduct in the Banking, Superannuation and Financial Services Industry

Submission to the Royal Commission

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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Introduction

CHOICE welcomes the opportunity to provide a written submission to the Royal Commission on the second round of hearings. Financial markets over time have become significantly more complex, in many cases unnecessarily so. For some, this has necessitated the need for formal financial advice to navigate this complexity. Good financial advice has been the victim of conflicts, including commissions and vertical integration since its rapid expansion in the 1980s. CHOICE reviews going back as far as 1987 have repeatedly shown the same problems of conflicted and poor quality advice. Yet we see the banks successfully bat away or water down reforms that would create lasting solutions to these conflicts. The trust of successive governments in the banks to adequately self-regulate has compounded these problems and made them drag on over decades.

We know that conflicts - including commissions, asset-based fees or simply a big bank placing pressure on advisers in their network – lead to advisers recommending products that are poor value or even harmful to their clients. We have also known the solution this problem for decades: remove the conflicts. Previous reform, including the Future of Financial Advice (FoFA) reforms went some of the way to address issues. But, thanks to very effective lobbying from the financial services sector, many gaps remain. CHOICE strongly encourages the Commission to recommend that conflicted remuneration and other conflicts in the financial advice sector are dealt with once and for all. This would mean removing all commissions, including grandfathered arrangements and those still allowed on life insurance advice. In means finally getting rid of opaque asset-based fees. It means taking a stand against vertically-integrated businesses using their owned-adviser networks to continue to sell products over providing genuine, useful advice.

Lasting solutions must also recognise that problems are not just with advice itself, but with the unnecessarily complex array of product offers that financial businesses have been allowed to develop. When combined with complicated taxation and pension structures, are forced to seek refuge with advisers offering to make this complexity clear. All too often consumers are hoodwinked into buying products that serve the advisors interests over the consumers. This creates an unenviable regulatory task for ASIC, forced to play a game of 'whack-a-mole' in rooting out bad advice. This is not to say there are not improvements that can be made to financial advice regulation. However, it does indicate a need to refocus on the underlying causes of consumers not having the confidence to make financial decisions unassisted. The solutions point to a heavier touch approach to product design to help simplify decisions for consumers.

There are some fundamental assumptions that need challenging, such as the universal need for financial advice and concepts of 'underinsurance'. Thankfully there are good solutions to draw on from the superannuation space, where policymakers have sought to design default products which are simpler to understand and help direct consumer preferences without the need for costly personal advice.

We have grouped our responses by theme and linked them to specific questions asked by the Royal Commission where relevant.

Summary of recommendations

Recommendation 1:

- Financial services laws incorporate a competition mandate which prioritises enhancing the welfare of Australians.

Recommendation 2:

- The Commission endorse the recommendation that ASIC be given a new real-time directions power.

Recommendation 3:

- The Commission recommends banning fees for ongoing service arrangements, including asset-based fees.

Recommendation 4:

- Expand the definition of a provision of financial advice (section 766B of the *Corporations Act 2001*) to account for a more holistic approach to financial advice.

Recommendation 5:

- Cease grandfathered commissions.

Recommendation 6:

- The Commission endorse the enhanced penalties and breach reporting standard recommended in the ASIC Enforcement Review.

Recommendation 7:

- The Commission recommend that financial service providers notify consumers when they identify a breach.

Recommendation 8:

- Financial service licensees bear the onus of proving they are meeting the client's best interests through transparent system controls.

Recommendation 9:

- That the regulator be given graduated response powers to help identify, name and shame licensees with poor compliance.

Recommendation 10:

- The Commission further explore the impact of a separation between advice and products sales as one of a suite of measures to address poor quality financial advice.

Recommendation 11:

- Establish a compensation scheme of last resort in line with the findings of the Ramsay Review.

Recommendation 12:

- Introduce a ban on conflicted remuneration, such as commissions on the sale of life insurance.

The purpose of financial services

The financial services industry plays an essential role in the lives of Australians, from providing for day-to-day transactions, to helping save for a home, to providing for a comfortable retirement. Given this sector's importance, we would expect to see high levels of community trust. However, CHOICE research found a mere 30% of Australians trust the banks.[1] From the

[1] The January 2018 CHOICE Consumer Pulse survey was designed and analysed by CHOICE with fieldwork by The ORU conducted with 1029 Australian households between 3 and 15 January 2018. Final data has been weighted to ensure it is representative of the Australian population based on ABS Census data from 2016.

hearings, it is increasingly clear that this trust deficit stems from a desire for fast profits at the cost of the long-term interests of the community. It is time to find policy solutions that rebalance this ledger.

Developing a regulatory framework which serves the community

Is there a particular regulatory culture that has developed in relation to the regulation of the financial advice industry? What is that culture? And what has contributed to its development?

Has the existing regulatory culture in the financial advice industry contributed to the occurrence of misconduct in the financial advice industry? What changes in regulatory culture might assist in reducing the incidence of misconduct in the financial advice industry?

Framing problems solely in terms of culture is not a useful way to analyse issues in the financial advice industry. While culture has a role to play, cultural solutions alone will not remove the types of misconduct identified in the Commission's hearings. Instead of starting with culture that is hard to measure and even harder to regulate, we need to properly define the purpose of financial services and build a regulatory framework that supports this purpose.

The financial services sector is adept at aggressively competing for customers and increasing profit in the short-term. As we've seen in the first two rounds of hearings, this unbridled approach has led to serious consumer harm. We need a rebalanced regulatory framework that does not merely focus on the needs of businesses but actively supports a broader consumer-centred purpose.

The heart of the problem in financial services is one of misaligned purpose. By contrast, at the core of the competition and consumer law is the concept of competition existing not for its own sake, but to enhance the welfare of Australians, expressed through the object of the *Competition and Consumer Act*.[2]

[2] *Competition and Consumer Act 2010, section 2: "The object of this Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.".*

Astoundingly, this same principle is largely absent from financial services regulation. Despite being a recommendation of the 2014 Financial System Inquiry, the chief regulator ASIC still lacks a competition mandate.[3] Currently ASIC's remit with regard to balancing consumer and business interests is illustrated by two key provisions within its objects:

> *(a) maintain, facilitate and improve the performance of the financial system and the entities within that system* ***in the interests of commercial certainty****, reducing business costs, and the efficiency and development of the economy; and*
>
> *(b)* ***promote the confident and informed participation of investors and consumers*** *in the financial system; and*

This is vastly different from the object of the Competition and Consumer Act, which has the simple yet important object [emphasis added]:

> *"…to* ***enhance the welfare of Australians*** *through the promotion of competition and fair trading and provision for consumer protection."*

Or indeed industry specific legislation such as the Telecommunications Act, which defines its object as providing a regulatory framework that promotes [emphasis added]:

> *(a) the* ***long-term interests of end-users*** *of carriage services or of services provided by means of carriage services; and*
>
> *(b) the efficiency and international competitiveness of the Australian telecommunications industry; and*
>
> *(c) the* ***availability of accessible and affordable*** *carriage services that* ***enhance the welfare of Australians****.*

Contrary to the object of the ASIC Act there is an explicit acceptance in consumer law and telecommunications law of the purpose of regulation being ultimately to enhance the welfare of Australians. The limited focus on "promot[ing] the confident and informed participation of investors and consumers in the financial system" is indicative of an outmoded regulatory

[3] Financial System Inquiry, 2014,'Final Report', p.237

framework that still places its emphasis on informing consumers and hoping the market will deliver good outcomes. Decades of experience would indicate this approach is doomed to fail.

The most recent example of this is the limited role the regulator was able to play in protecting people from timeshare schemes. These schemes lock consumers into contracts which can run for over 60 years, and cost as much as $450,000.[4] The cost of services are often masked through elaborate points systems which make comparison to other holiday accommodation difficult. CHOICE analysis found that the costs associated with a timeshare scheme in one example were 938% more expensive than the cost of booking similar accommodation outside of the scheme. In the examples CHOICE analysed, the return on investment was non-existent.

However, given that advisers selling timeshare schemes are exempt from parts of the FoFA laws,[5] we have observed evidence of financial advisers using high pressure sales tactics to drive people into these schemes. CHOICE pushed for a regulator review into this sector, which it did, handing down its findings in April 2018.[6] Given ASIC's limited mandate to focus on 'confident and informed participation' of consumers in the financial system, it was unable to take a broader view of the product's impact on the welfare of Australians. Instead it was handcuffed to tinkering with information disclosures and extending cooling off periods slightly.[7] This is despite widespread acceptance that disclosure is an inadequate consumer protection and cooling off periods simply do not work.[8]

Financial services regulation needs to be rebalanced to ensure that policy interventions to harmful products go beyond adding on more disclosure. Giving financial service regulation a broader aim of enhancing the welfare of Australians unshackles the regulator to take a more active role when there is evidence of consumers being recommended to take on costly, low-value products that can lead to significant harm.

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[4] CHOICE, 2018, 'CHOICE calls for clean-up of timeshare financial advice', available at: https://www.choice.com.au/about-us/media-releases/2018/february/timeshare-schemes

[5] Treasury, 2018, 'Key reforms in the regulation of financial advice', p.6

[6] ASIC, 2018, 'Time-sharing schemes: Update on the status of our review of the policy settings', available at: http://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-272-remaking-asic-class-orders-on-time-sharing-schemes/time-sharing-schemes-update-on-the-status-of-our-review-of-the-policy-settings/

[7] ASIC, 2018, 'Time-sharing schemes: Update on the status of our review of the policy settings', available at: http://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-272-remaking-asic-class-orders-on-time-sharing-schemes/time-sharing-schemes-update-on-the-status-of-our-review-of-the-policy-settings/

[8] Consumer Action, 2016, 'Cooling off doesn't work: New research', available at: https://consumeraction.org.au/cooling-off-doesnt-work-new-research/

Recently the Federal Government announced its intention to give ASIC some responsibility for competition issues, with the exact scope yet to be defined.[9] We see enhancing the welfare of the community as the core purpose of competition in financial services. Addressing this high level issue is an essential starting point to ensure financial services as a whole is capable of balancing its competing interests.

Relying on self-interest driven competition alone, without reference to consumer welfare, has led us to a place of ineffective self-regulation with people suffering heavy losses.

Recommendation 1:

- Financial services laws incorporate a competition mandate which prioritises enhancing the welfare of Australians.

ASIC directions power

The ASIC Enforcement Review has provided policy recommendations which have the capacity to address some of the problems we have seen in the financial advice round of hearings. Again, the focus needs to move away from ephemeral ideas of culture and focus on what powers the regulator could use to effectively regulate this sector for the benefit of Australians.

It was apparent through the evidence provided by ASIC Commissioner Peter Kell that the current options of either enforceable undertakings or court action are not appropriate in all circumstances. Using the AMP fee for no service case study as an example, here ASIC was able to achieve an enforceable undertaking for remediation. However, an enforceable undertaking by its nature relies on a negotiated outcome between the financial service provider and the regulator. If no agreement can be reached the regulator is left to pursue lengthy court action, which significantly delays consumer access to remediation. For a consumer, depending on the severity of the breach, these delays can have life-altering consequences. They could mean the difference between someone spending their last days with financial security or struggling to afford basics on a meagre pension. The impact of a four-year delay in the context of a human life can be devastating.

[9] White, A., 2018, 'Financial services competition role for ASIC as agenda expands', *The Australian*, 19/3/2018, available at: https://www.theaustralian.com.au/business/financial-services/financial-services-role-for-asic-as-agenda-expands/news-story/70f5c92cdb7fc02835603703a6abdd16

To deal with this problem the regulator needs real-time powers to direct remediation quickly and, if required, at a later date back this up with court enforcement. The principle should always be to remediate impacted consumers as soon as possible.

We welcome the Government's in-principle support for this recommendation and encourage the Commission to likewise support this proposal.

Recommendation 2:

- The Commission endorse the recommendation that ASIC be given a new real-time directions power.

Fees for no service

Do clients receive any meaningful benefit from ongoing service arrangements?

On the evidence it is difficult to see what meaningful benefits clients receive from ongoing service arrangements. In theory these have the potential to provide timely advice to guide action at crucial investment decision times. In practice they have been abused by industry players and led to consumers being charged for services that they never received. CHOICE shares the views expressed by ASIC Commissioner Peter Kell that,

> *"if ongoing services are improperly applied, then they do, unfortunately have some similarities with some of the more problematic aspects of commissions, being that they are recurring, they can be invisible to the customer from a practical point of view – and there may be no clarity around what exactly the customer is getting or supposed to get in – in return for this payment."*[10]

The Future of Financial Advice (FoFA) reforms attempted to increase transparency by requiring advisers to obtain client agreement to ongoing advice fees, and enhanced disclosure of fees and the services associated with ongoing fees. The FoFA reforms, while important, did not go far enough. Consumer advocates strongly pushed for the laws to ban all conflicted remuneration but this was opposed by industry. Further steps must be taken to properly remove

[10] Peter Kell, Witness Statement

conflicted remuneration in financial advice which leads to adverse outcomes for consumers. The systemic charging of fees for no service may, as the questions put by the Commission suggest, go to strong cultural or attitudinal problems in the sector. Banning ongoing fees for advice and forcing advisers to prove their worth by having to pitch for repeat custom would remove the conflicts that drive poor outcomes in the sector.

Asset-based fees

As part of ongoing service arrangements, consumers are often required to pay asset-based fees, which are calculated as a percentage of funds under management. It is also common practice for ongoing service arrangements to automatically deduct payments from a client's account, and clients are very rarely provided with an invoice for fees. This tactic exploits the status quo bias, an established psychological bias which states that an individual has a stronger preference for the current state of affairs, and is less likely to change alter their behaviour, irrespective of whether the behaviour is good for them.[11]

Asset-based fees obscure the true cost of a service and share many of the deleterious impacts on consumers as other ongoing service arrangements or commissions. Asset-based fees bear no relationship to the work actually done by the financial adviser or the quality of that work conducted.

At every step of the advice process, institutions 'clip the ticket' of their client's savings.[12] Consumers are hit with an asset-based fee when they engage with an adviser. They are hit with an asset-based fee when they access an investment platform. They are hit with an asset-based fee for each product they invest in on that platform. With vertical integration, consumers can be slugged three separate asset-based fees by the same institution, who simultaneously provide the advice, offer the platform, and sell their own financial products. These fees are intentionally obfuscated by vague names, such as 'adviser service fees', 'platform administration fees', and 'investment management fees'. They also prey on shortfalls in financial literacy, for example a 0.75% fee, may on the outset seem insignificant. Yet a 0.75% 'platform administration fee' to simply access a platform for a $500,000 investment ends up costing a consumer $3,750 a year. Further, asset-based fees unfairly penalise those with more savings. It is very unclear the different service that is provided for an individual who has $200,000 invested in a platform,

[11] Chuah, S.H., Devlin, J., 2010, 'Behavioural Economics and the Financial Services Consumer: A Review', available at: https://www.nottingham.ac.uk/business/businesscentres/crbfs/documents/researchreports/paper92.pdf
[12] See ASIC MoneySmart, 'Financial advice costs', https://www.moneysmart.gov.au/investing/financial-advice/financial-advice-costs

compared to another person with $100,000 invested, yet the first individual is slugged double to simply access the service.

Asset-based also fees create conflicts of interests that may encourage the adviser to give poor quality advice. They discourage strategic advice, such as personal debt reduction, like paying down a home loan or credit card, for which the adviser would not earn a fee, towards recommendations that acquire products in which an adviser can extract an asset-based fee. Once established, asset-based fees do not provide an incentive to provide ongoing services to the client, because the financial adviser is paid regardless. They have consistently been a source of poor consumer outcomes for decades, and have driven disastrous business models.

Recommendation 3:

- The Commission recommends banning fees for ongoing service arrangements, including asset-based fees.

Promoting an advice rather than a sales culture

As identified above, the current focus of the legislation is on framing advice around product sales. This allows for a narrow view of financial advice. It frames it mostly in terms of selling or recommending products. Section 766B of the *Corporations Act (2001)* states:

(1) For the purposes of this Chapter, ***financial product advice*** means a recommendation or a statement of opinion, or a report of either of those things, that:

(a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or

(b) could reasonably be regarded as being intended to have such an influence.

Rather than defining advice as an activity linked to financial products, the legislation could instead define advice as a larger activity, designed to guide consumers through financial decisions. At times, this could involve product recommendations but the best quality advice may instead be to take no action or behave in a different way (save or reduce spending, for example).

Recommendation 4:

- Expand the definition of a provision of financial advice (section 766B of the *Corporations Act 2001*) to account for a more holistic approach to financial advice.

Grandfathered commissions

To what extent does the continued legislative condoning of grandfathered commissions shape and influence the culture and attitudes of financial advice licensees so as to create a disconnect between community expectations as to the charging of fees and the tolerance of licensees for the charging of fees for no or little service?

The FoFA reforms were predicated on a clear understanding that commission-based payments led to conflicted advice, i.e., advisers giving advice not in the best interests of their clients. Exemptions were fought for by industry to ease the shock of moving to a business model with fewer conflicts. One of these exemptions allowed advisers to continue to earn commissions on agreements entered into prior to the FoFA reforms coming into effect. The original intent of grandfathering was to "facilitate a smooth transition to the new regime for industry whilst ensuring the ban on conflicted remuneration commenced as soon as practicable."[13] Counter to this intent, it is clear from the evidence in this round of hearings that members of industry have sought to prolong the existence of conflicted remuneration by taking steps to evergreen conflicted remuneration rather than remove it entirely.

The evidence which came to light during the hearings showed financial advice licensees have systemically prioritised maintaining grandfathered commissions over acting in the best interest of their customers. Including:

- Evidence that a subsidiary of ANZ, RI Advice, purchased advisers without undertaking appropriate due diligence, before the 1 July 2013 FOFA deadline, to ensure that they received ongoing grandfathered commissions.[14] This included offering $150,000 to one financial planner, despite the fact he had failed his initial competency exam, continued to provide consistently poor advice, and received his first complaint just three months after joining ANZ.[15]

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[13] Treasury, 2018, 'Key reforms in the regulation of financial advice', p.8
[14] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, transcript, 20th April 2018, p.1527
[15] ibid, 20th April 2018, p.1492

- Evidence that AMP management made a concerted effort to structure their business to allow ‘orphan’ clients to continue to be charged grandfathered commission, even though their clients changed advisers.[16]

- Evidence that even five years after the passing of FoFA, 60-70% of fees that AMP pays to its advisers are commissions, rather than fees-for-service.[17]

- Evidence that Commonwealth Financial Planning Limited (CFPL) has made no efforts to ‘dial down’ grandfathered commissions to zero, and that the CFPL views grandfathered commission as simply providing “some relief” to their bottom line.[18]

These examples are not isolated incidents. They exist on an industry-wide level. Financial service licensees have systematically endeavoured to profit from existing pre-FoFA customers. This behaviour falls well below community standards and expectations. It has been unequivocally shown that commissions distort the quality of financial advice offered to consumers, and grandfathered commissions are no exception. The current exemption has helped to foster the attitude that advisers are justified in continuing to reap these commissions. Industry members have sought to exploit this exemption and it is past time to close it down.

Should grandfathered commissions cease?

Industry has been given ample time to adjust to a new business model with fewer conflicts, yet large elements of it have failed to make the move and seem intent on squeezing every last cent from this tainted advice. Consumers stuck in these arrangements will continue to be slugged with large commission-inflated fees for products that are likely not in their best interests. Attitude change will not come from within, with players like AMP denying it should be up on criminal charges for misleading the regulator over the independence of the report it commissioned into the fee for no service breaches of the law.[19] Change will only come from a legislated ceasing of grandfathered commissions.

Ending grandfathered commissions will also serve as a catalyst for advisers to offer new advice to consumers who may currently be acting on conflicted advice. Turning off these conflicted revenue streams will force advisers to work for future income by offering advice to these clients which meets the best interest test.

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[16] ibid, 17th April 2018, p.1138
[17] ibid, 17th April 2018, p.1153
[18] ibid, 19th April 2018, p.1345
[19] SMH, 2018, ‘AMP 'strenuously denies' it should face criminal charges’, 4/5/2018, available at: https://www.smh.com.au/business/banking-and-finance/amp-denies-it-doctored-independent-report-20180504-p4zdcz.html

Recommendation 5:

- Cease grandfathered commissions.

Improving breach reporting

How should financial services licensees ensure that customers of their authorised representatives are adequately protected while the licensee investigates the conduct of the authorised representative?

What is an acceptable period of time after identifying that a client has been or may have been provided with inappropriate financial advice to inform the client of that fact?

What is an acceptable period of time after identifying that a client has been or may have been provided with inappropriate financial advice to remediate the client for any losses suffered?

Breach reporting has consistently failed consumers. The preliminary findings that emerged from ASIC's Breach Reporting Surveillance are damning on the level of industry delay and deception.[20] It takes on average four to five years from an event occurring before a customer has the opportunity for remediation due to inaction by industry. There is no justification for delay; customers have a right to know if they have been provided with inappropriate advice as soon as possible.

CHOICE welcomes Treasury's ASIC Enforcement Review recommendation to increase penalties, both criminal and civil, for failure to report.[21] Without adequate penalties there is a risk that a financial service licensee will see not reporting as simply the cost of doing business.

CHOICE also supports the Enforcement Review's recommendation that breach reporting should be determined by reference to an objective standard of 'reasonableness'.[22] Financial services licensees have been able to hide and delay reporting due to the subjective nature of the current guidelines. This delay has directly resulted in prolonging consumer suffering and harm. Larger licensees have hidden behind the subjective requirement that requires a licensee to consider,

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[20] Peter Kell Witness Statement, paragraph 140
[21] Treasury, 2017, 'ASIC Enforcement Review Taskforce Report' December 2017
[22] Treasury, 2017, 'ASIC Enforcement Review Taskforce Report' December 2017, p.6

"the impact of the breach or likely breach on the licensee's ability to provide the financial services covered by the licence".[23] This has caused an unintended consequence where larger licensees are less likely to report, due to their relatively larger size, than a small licensee, despite the same number of consumers being impacted.

CHOICE maintains that breach reporting should extend beyond breaches that only involve financial loss. As the ASIC Enforcement Review notes, consumer harm is not restricted to financial loss, it may also arise from a lack of adequate disclosure. Inadequate disclosure, on a widespread scale might be 'indicative of a broader systemic failing within the licensee.'[24] In the case of long term investments, such as superannuation or life insurance the nature of the loss may not be discovered until long into the future. The new powers would allow ASIC to take a proactive role in examining the behaviour of licensees, and in certain circumstances, would prevent future financial harm from occurring.

Recommendation 6:

- The Commission endorse the enhanced penalties and breach reporting standard recommended in the ASIC Enforcement Review.

Informing consumers of a breach

We encourage the Commission to review the role data breach notification laws have played in harm minimisation in the privacy space. The intent of this privacy law is to inform consumers if a breach "would be likely to result in serious harm to an individual".[25] This serves two important functions. First, it involves the affected consumer in the process, and allows them to mitigate potential risk. Second, it promotes broader trust in the system, as it shows that breach identification is a serious matter.

CHOICE sees value in extending the principles of data breach reporting to breach reporting for financial services licensees. When a licensee first reports a breach to ASIC, consumers who are potentially affected should be informed. This reporting could invite affected customers to provide extrinsic evidence that may help confirm the breach above. This brings affected customers into the process and allows them to take steps to reassess their investments and protect themselves from further harm.

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[23] Corporations Act 2001 Section 912D
[24] ASIC 2017, 'Position and Consultation Paper 1 – Self-reporting of contraventions by financial services and credit licenses', p.12
[25] Office of the Australian Information Commissioner, 2018, "Data breach preparation and response" https://www.oaic.gov.au/resources/agencies-and-organisations/guides/data-breach-preparation-and-response.pdf

Recommendation 7:

- The Commission recommend that financial service providers notify consumers when they identify a breach.

Improving licensing regulation

Is it possible to implement a single system for professional discipline of financial advisers? Would structural changes to the financial advice industry be required to bring that about? Would a system of licensing at both an individual and an entity level be more appropriate than the existing system of licensing only at the entity level?

We see benefit in lifting professional standards in the adviser sector and have previously called for improved educational standards and greater responsibility taken by professional bodies. However, we note the limited nature of any self-regulatory effort and the need for a properly empowered regulator presence to pick up the inevitable slack self-regulation creates.

CHOICE concerned that a dual system of licensing at both an individual and entity level will create confusion in lines of responsibility and lead to less efficient regulation with minimal additional benefit. Monitoring at the advice level alone is resource intensive and ignores the cause of the problem, which is rarely a few 'bad apples' but a systemic problem inextricably tied to conflicted remuneration and business structures.

Financial service licensees are already required to manage conflicts of interest[26], but without specific rules this becomes difficult to police. The current laws are too vague and leave ASIC with limited powers to take action when needed. One solution would be to reverse the onus and require financial service licensees to demonstrate they have systems in place to ensure they act in the client's best interests. With the increased use of technology, such as robo-advice, it may simply be a matter of proving that the algorithm for advice is robust enough to ensure the best interests test is met. This would greatly reduce the regulatory cost, while making monitoring far more effective.

[26] ASIC Regulatory Guide 181 http://download.asic.gov.au/media/1241003/rg181.pdf

Recommendation 8:

- Financial service licensees bear the onus of proving they are meeting the client's best interests through transparent system controls.

ASIC also needs an enhanced regulatory toolkit to respond when breaches are detected. Its current ability to suspend a company's licence is useful for the most serious cases but may not be an appropriate or proportionate response for more minor compliance failures that nonetheless need to be dealt with. A graduated response scheme is needed to act as a real deterrent for licensees who fail to meet their duty. This could include:

- Where the regulator suspects poor compliance, give it powers to direct the licensee to fund independent auditing of individual advice. This should be commissioned by ASIC, to avoid the problems identified in the AMP case study of doctored independent reports.
- In addition to its existing powers to pursue penalties, publicly naming and shaming licensees where independent audits show poor levels of compliance with the best interest duty.

Recommendation 9:

- That the regulator be given graduated response powers to help identify, name and shame licensees with poor compliance.

Vertical integration

Can financial advisers effectively manage the conflicts of interest associated with providing advice as a representative of an institution that also manufactures financial products? Is it necessary to enforce the separation of products and advice?

Vertical integration has led to conflicts and poor customer outcomes for decades. In 1987 CHOICE conducted its first shadow shop of financial advisers, and raised concerns about vertical integration as we saw a clear preference for advisers to recommend lower quality products of their parent bank.[27] In the 30 years since, the same problems persist with the 2018 ASIC review into vertically integrated businesses finding, despite the introduction of a best interest duty, that advisers are still overwhelmingly recommending products from their own

[27] CHOICE, 1987, 'How to choose an investment advisor', April 1987, p.29

parent business.[28] The research found that while in-house products accounted for an average of 21% of products on licensee's product list, after receiving advice 68% of funds were invested in in-house products. It would be miraculous if such a large number of advisers were able to find a superior product from an in-house list on so many occasions. Sadly, it wasn't a miracle, with ASIC finding the advice failed in 75% of cases to comply with the law, such as the duty to act in the best interests of the client.

The current system of vertical integration makes it exceedingly difficult to trust advisers in integrated businesses. The ASIC report shows that an adviser is not just conflicted by commissions but can be conflicted by their employer if they wish to remain employed in businesses which have both a product and advice function. It is important to remember that this is not just a problem of large banking institutions, indeed many smaller businesses may offer both advice and products.

Equally, we do not see breaking up vertically integrated businesses on its own as the panacea to problems of conflicted advice. Indeed, in some cases it is more efficient for a product provider to give advice where there are proper controls in place to protect the consumer. For example, some intra-fund advice offered by superannuation funds can help consumers better understand the value of making extra contributions to an existing fund without the added cost of more extensive personal advice.

The issue of vertical integration was prominent within CHOICE's Royal Commission consumer survey.[29] One respondent said:

"*Most financial advisors are not independent and are really only salespeople. Getting impartial advice at a reasonable price is difficult.*"

Another said:

"Financial advisor was tied to one company but other various plans which appeared to be from different funds. In fact, they were are [sic] from the same company. Advisor changed alliance to another company and strongly urged us to follow suit as it would give us a better return. Again,

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[28] ASIC 2018, Report 562, Financial advice: Vertically integrated institutions and conflicts of interest

[29] CHOICE, 2018, 'Royal Commission survey' , data was collated 10 January – 5 February, 2018, the sample is self-selecting from an online survey asking CHOICE supporters and the general public to share their priorities for the Royal Commission and experiences where a financial service provider had not met the respondents standards or expectations, n=2,820

fees were charged for the new account, on top of his ongoing fees. Returns were essentially the same as the previous fund."

Another survey respondent was unhappy with:

"Financial advice that pushed bank products under the guise of independent financial advice. Advisor would not reveal details of the product unless we signed up."

Consumers need to have trust that their adviser is truly independent and not simply recommending in-house products that will get the adviser a bigger bonus or other staff incentives. This is an area which requires further work. There are significant conflicts that warrant an end to vertical integration, however on its own this is an imperfect solution.

Recommendation 10

- The Commission further explore the impact of a separation between advice and products sales as one of a suite of measures to address poor quality financial advice.

Compensation scheme of last resort

Throughout this submission we have called for a shift in thinking away from self-regulation as a first resort. This approach recognises that properly equipped, fast acting regulators are best positioned to play a harm prevention role in the financial services sector. While harm prevention should be the primary focus, ensuring consumers are protected when the system fails is also vital. Currently the financial services sector lacks a last resort scheme capable of compensating consumers for these failures, leaving many without remedy.

The *Corporations Act 2001* and *National Consumer Credit Protection Act 2009* impose an obligation on licensees to provide compensation to consumers for certain losses incurred.[30] However, there remain circumstances when consumers are left without compensation, typically when financial service entities become insolvent. This risk is heightened in an environment where large financial providers with significant capital holdings move away from the advice sector. In their place is likely to be a series of smaller advice businesses who is many cases will not have the resources to compensate consumers for improper advice which leads to loss.

[30] *Corporations Act 2001* and the *National Consumer Credit Protection Act 2009*

To be clear, the ability of large corporations to compensate consumers is not a sufficient reason to not consider the breaking up of advice and product arms of these companies. Indeed, the conflicts inherent in this current practice can be pointed to as the cause of many issues within the system. Rather, a compensation scheme of last resort is a necessary consumer protection to create trust and a much-needed shared accountability across this sector regardless of its future structure.

The current lax attitude to compliance and the ease with which suspect advisors at one business can reinvent themselves at another is indicative of an industry that lacks a sense of collective responsibility for the actions of its peers. Educational standards and ethics classes alone will not address this cultural shortfall. Instead, an industry funded compensation scheme of last resort will firmly place an economic imperative to lift standards at the board, owner and professional body level of this sector.

The human impact of failures in financial advice can be catastrophic. In some cases, people have invested their retirement savings or leveraged their homes based on poor advice, only to lose it all. The stress placed on a person can impact both mental and physical health. Ultimately, the costs of these types of failures are borne by the wider Australian community through increased reliance on support services, including social security.

CHOICE supports the observations made by the Ramsay Review as to the benefits of a compensation scheme of last resort.[31] The scheme should be designed to ensure it is properly funded by financial firms and capable of compensating consumers in the event of failure. Such a scheme should shift the cost of misconduct away from the community and onto the sectors that are causing harm.

We maintain that in a properly functioning financial services sector the focus should be on harm prevention and empowering regulators as a first resort. However, when the system fails the sector as a whole should be responsible, through the funding of a last resort compensation scheme, to ensure consumers are not left financially ruined and without remedy.

Recommendation 11:

- Establish a compensation scheme of last resort in line with the findings of the Ramsay Review.

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[31] September 2017, Ramsey Review, 'Supplementary Final Report – Review of the financial system's external dispute resolution and complaints framework', p.41, available at http://192.195.49.161/ConsultationsandReviews/Reviews/2016/Review-into-Dispute-Resolution-and-Complaints-Framework/Final-Report

Life insurance commissions

Should the statutory carve-outs to the ban on remuneration, including the recent carve-out in relation to insurance commissions, be maintained?

A 2014 ASIC review of retail life insurance found systemic problems within the industry.[32] 37% of advice failed to prioritise the needs of the client and comply with the law. Further, high up-front commissions are strongly correlated with poor advice; 45% of advisers who were paid through up-front commissions failed to comply with the law. The statutory carve-out for life insurance commissions creates misaligned incentives, and results in poor consumer outcomes.

CHOICE acknowledges the recent legislative changes to both cap upfront commissions and to introduce clawbacks. The reforms are an improvement from previous arrangements, however, they do not remove the conflict, they simply make it slightly less profitable. Given the overwhelming evidence of consumer harm related to commission-based sales, commissions need to be permanently banned, as they are for other types of financial advice. ASIC should be directed to use its regulatory power to introduce a glide path to zero for the removal of life insurance commissions, with the aim of giving advisers a reasonable timeframe to develop new revenue streams while protecting consumers from further exploitation.

Recommendation 12:

- Introduce a ban on conflicted remuneration, such as commissions on the sale of life insurance.

[32] ASIC (2014), *Report 413: Review of retail life insurance advice*, pp. 5-7.